

COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Request for Comments on the)	
Procurement of Default Service Power)	D.T.E. 04-115
Supply for Residential and Small)	
Commercial and Industrial Customers)	

INITIAL COMMENTS OF DIRECT ENERGY SERVICES, LLC

INTRODUCTION

Direct Energy Service, LLC (“Direct Energy”) appreciates being given the opportunity to respond to the Department’s Request for Comments on the important issue of default service procurement. Before providing its general and specific responses to the Department’s questions, Direct Energy would like to provide some background on the Company.

Direct Energy is a leading North American retailer of energy and related services. We serve over 5 million customers in North America. Direct Energy supplies energy to consumers in Texas, Ohio, Pennsylvania, Michigan, Massachusetts, Rhode Island, and Connecticut and also in the Canadian provinces of Ontario and Alberta. In Texas and Alberta we supply energy on both a regulated and an unregulated basis. We provide energy-related services in Canada and in many parts of the United States. In Massachusetts we supply natural gas to commercial and industrial customers. Our goal here is to expand our offering to supply electricity to this customer class as well as to residential and small commercial customers as the opportunity ripens.

Direct Energy's parent company, Centrica plc, has over 33 million customer relationships worldwide. Centrica has a market capitalization of \$17.5 billion and \$22 billion in annual revenues. In the United Kingdom, Centrica owns approximately 3,000 MW of generation capacity to support its retail electricity customer base. The company is seeking to invest in excess of \$1 billion in generation capacity over the next five years.

In North America, we also own electricity generation and gas production assets in support of our retail supply business. To support our retail gas supply obligations, we own and operate in excess of 4,000 gas wells in Alberta and British Columbia. We recently completed the acquisition of two power plants in North America. We now own and operate the 540 MW Bastrop power station and the 477 MW Frontera power station to supply our retail customer base in Texas, allowing us to serve approximately 25 percent of our power needs.

Direct Energy's comments in response to the Department's request are informed by this experience as both a regulated and unregulated energy market participant in various North American and European jurisdictions, and in various capacities (as retailer, wholesale market participant, and power station owner and operator).

EXECUTIVE SUMMARY

The seven-year transition period called for by the 1997 Restructuring Act has not brought the results the Legislature expected in terms of the development of a robust competitive retail market. The market for medium and large commercial and industrial customers has reached a certain level of development (although, Direct Energy notes, not nearly the level reached in other states), but the market has failed to develop for residential and small business customers in any meaningful way. As a result, when the transition period ends and standard offer expires, over 95 percent of the small customers in Massachusetts will be receiving default service from their local distribution utilities. This is not what the Legislature envisioned. The Legislature envisioned that as a result of the Act customers would receive electric service from competitive suppliers, and that the retail market would “(i) provide electricity suppliers with the incentive to operate efficiently, (ii) open markets for new and improved technologies, (iii) provide electricity buyers and sellers with appropriate price signals, and (iv) improve public confidence in the electric utility industry.”

Direct Energy encourages the Department to investigate why the competitive market has not developed in this manner, take all steps within its authority to remove the continuing barriers to entry that act to exclude even efficient competitors from the market, and work closely with the Legislature to implement other remedial measures that may require authority the Department does not now possess.

The two most significant barriers to entry are the continued inclusion in distribution rates of retail costs such as billing and customer service and the lack of any means of scale entry into the retail market. Direct Energy has proposed a market

structure that would lead to a robust retail market in which all customers have real choices from a number of competing suppliers. The Direct Energy proposal, which includes a requirement that the Department conduct an auction of the right to serve small customers at retail, would also ensure that there will be sufficient new generation available to address load growth and generation plant retirements. A summary of the Direct Energy proposal is attached to its Comments in this proceeding.

The possible changes in procurement practices mentioned in the Department's Request for Comments would take the retail market for small customers in the wrong direction in important respects. In focusing on the details of **wholesale** default service procurement, the Request for Comments diverts attention away from the pressing issue of the lack of development of a robust **retail** market for small customers. Further, requiring utilities to adopt a more complex portfolio approach to default service procurement sacrifices a number of critical policy considerations in favor of marginally-increased "price certainty" for small customers. In these Comments, Direct Energy discusses these policy considerations in detail, and encourages the Department not to abandon the quest for a workable retail market for small customers in Massachusetts.

GENERAL COMMENTS

The Department's Request for Comments comes at an interesting time. The end of the transition period is less than two months away. At that time, standard offer service will expire, and about 1.5 million residential and small business customers will be switched to default service automatically pursuant to statute. As a result, as of March 1, 2005, over 95 percent of the residential and small business customers in the Commonwealth will be taking default service from a utility seven years after enactment of the Restructuring Act. Effectively all mass market customers not living on Cape Cod (where the Cape Light Compact remains the only municipal aggregation program implemented successfully during the seven-year transition period) will be taking bundled utility service.

Considering these facts and the utter lack of competitive options for mass market customers, Direct Energy would have expected the Department to open an investigation into the reasons the existing market structure has not delivered what the Legislature clearly had in mind when it passed the Restructuring Act, rather than examine arcane details of the utility procurement methodology. While the Legislature may not have wanted competition for competition's sake, it clearly wanted competition for **the customer's sake**. The Legislature expected that restructuring would lead to "a framework under which **competitive producers will supply electric power** and customers will gain the right to choose their electric power supplier." St. 1997, c. 164, § 1(c) (emphasis added). The Legislature expected that competitive producers would supply electric power to customers under the new structure because:

Competitive markets in generation should (i) provide electricity suppliers with the incentive to operate efficiently, (ii) open markets for new and improved technologies, (iii) provide electricity buyers and sellers with appropriate price signals, and (iv) improve public confidence in the electric utility industry.

St. 1997, c. 164, § 1(g);

The Legislature expected that retail competition would bring

long-term rate reductions [which] can be achieved most effectively by increasing competition and enabling broad consumer choice in generation service, thereby allowing market forces to play the principal role in determining the suppliers of generation for all customers.

St. 1997, c. 164, § 1(k);

The Act itself makes it clear that the Legislature did not view a competitive retail market for **all customers** as a mere possibility or one of several options that might be considered for implementation by the Department during the transition period. The fact that there is no real competitive retail market after seven years of restructuring (and more importantly, after consumers have paid hundreds of millions of dollars to utilities in stranded costs) must be seen as a failure.

Direct Energy believes the Department should react with alarm to the failure of restructuring to create a robust retail market that serves all customers. The alarm should be over the failure of the current market structure to provide the Commonwealth's consumers with a market that will provide long-term supply security and price competitiveness. The Department should be doing everything within the scope of its statutory authority to identify, assess, and implement measures that would create success and fulfill the goals of the Restructuring Act. If necessary, the Department should work closely with the Legislature during the current session to pass legislation that would invest the Department with the authority to implement the appropriate measures.

In our view, while the Department has been devoting time and effort to the issue, and appears to have good policy intentions regarding the state of competition for retail electric customers, the Department has missed opportunities to implement reasonable measures to establish a robust retail market. In particular, the Department has not addressed what are probably the two most significant barriers to entry faced by retailers: the continued inclusion in distribution rates of retail costs such as billing and customer service, and the lack of any means of scale entry into the retail market.

In DTE 02-40-B and DTE 03-88, over the objections of competitive retail suppliers, the Department refused to include what it called “indirect retail costs” in the costs to be removed from distribution rates and included in default service rates, focusing instead on the relatively miniscule “procurement-related wholesale costs” and “direct retail costs” incurred by utilities in providing default service. DTE 02-40-B, at 15-17; DTE 03-88, Order Opening Investigation, at 3-5. The result is that default service remains essentially a “pass-through” wholesale service in which consumers pay twice for various commodity retailing charges if they switch to a competitive supplier, rather than being a true retail product against which competitive retailers could fairly compete.

By allowing these retailing charges to remain locked in utility distribution rates, which consumers cannot avoid, the current market structure prevents the entry of even the most efficient retailer. So long as the utility continues to collect these costs in distribution rates, the forces of competition cannot be brought to bear on these charges, eliminating any possibility that these retailing charges to consumers can be reduced by the entry into the market of more efficient retailers. In fact, quite the reverse is true. For most of the transition period, the distribution rates of the Commonwealth’s two largest

utilities have been subject to rate freezes. Massachusetts Electric Company, DTE 99-47 (2000); NSTAR Electric, DTE 99-19 (1999). As a result, the utilities have an incentive to become more efficient in providing these retail services (that is, reduce the costs of providing them), but any savings go to utility shareholders rather than to customers. This also provides the utilities with a strong incentive to oppose any change in the rate treatment of these retail services, which gives them a windfall profit so long as delivery rates remain frozen. The overall result is a market structure in which more efficient producers are kept out while customers are prevented from enjoying the benefits of improvements in efficiency that utilities might implement. This is the **opposite** result from the one envisioned by the Legislature when it passed the Restructuring Act.

However, all such arguments for or against proper unbundling are eliminated if the program proposed by Direct Energy in Appendix A is adopted. In the absence of proper unbundling, even with potential changes in default service procurement, mass market consumers in the Commonwealth still will not have the energy choices and innovation envisioned by the Legislature in the Preamble to the Act.

In DTE 02-40-B, the Department also refused to take any steps, such as designating non-utility suppliers as default service providers pursuant to G.L. c. 164, § 1B(d), that would have allowed competitive suppliers some opportunity for scale entry to overcome the utilities' advantage of 100 years of monopoly control over the retail market. In taking actions such as these, the Department has not removed all unreasonable structural inequities that are preventing even efficient competitors from gaining entry and providing the true benefits of competition - innovation, service, and quality - to Massachusetts customers.

Direct Energy's view is that the Department should move quickly to adopt a market structure that will lead to a robust retail market in which all consumers have real choices from a number of competing retail suppliers. Direct Energy has made such a proposal in the past, and it remains the single most viable means for bringing the benefits of competition to all customers and also ensuring that there will be sufficient new generation available to address load growth and generation plant retirements. Under the Direct Energy proposal, the Department would conduct an auction of the right to serve small customers **at retail**. Among other benefits, this would allow the scale entry into the Massachusetts market of a number of retail energy companies that have both the technical ability to provide sophisticated portfolio management and also the financial strength to invest in new generation to serve their customer bases and bring additional liquidity to the wholesale markets. More important, this proposal would create overnight a number of competitors who would seek to constantly improve their product and service offering – the real purpose of restructuring. A summary of this proposal is included as Appendix A to these Comments.

Far from exploring the market structure issues that Direct Energy believes should be the Department's focus as the transition period comes to a close, it appears that the Department is now content to "ensure that smaller customers achieve the full benefits of the competitive **wholesale** market." Request for Comments at 2. This is a fundamental misunderstanding of electricity restructuring. The Department must recognize that wholesale competition will only thrive when there is a robust retail market. Simply put, there will not be any long-term "benefits of competitive wholesale markets" without a vibrant retail market that allows consumers (directly and indirectly through their

suppliers) and producers to meet in a fair marketplace. Rather, under the Department's model, consumers will simply be left with a series of shorter-term purchases from generation companies that will be operating in a never-ending cycle of boom and bust. Right now, given the build out of generation in the late 1990s, it may make sense to hold an auction and get the lowest possible price. But what happens when the region begins to need new generation? Who is going to build generation based on the right, but not the certainty, that they can win a one- or two- or three-year contract to supply some variable amount of electricity? Now is not the time to focus on what procurement options are most efficient.¹ Now is the time to focus on creating a workable electricity market that is sustainable for the longer-term.

Moreover, moving from a system of default service procurement that the Department adopted less than two years ago to one in which utilities begin to purchase (but not own the risk for) complex portfolios of wholesale contracts, some as long as two or three years as suggested in the Request for Comments, will only take the Commonwealth further away from a workable retail marketplace.

First, experience has shown that large retail suppliers like Direct Energy and its parent company, Centrica, are better able than local utilities to act as portfolio managers for large groups of retail customers. They tend to have customer bases and relationships that allow them to contract for a longer term than distribution companies which, in the case of Massachusetts utilities, are providing only pass-through generation service to the

¹ While not the subject of this Request for Comments, Direct Energy urges the Department to investigate as soon as practicable the use of hourly pricing for medium and large default service customers much as New Jersey has done. Direct Energy believes it is clear that default service pricing for medium and large commercial and industrial customers should be as close to hourly pricing as possible. Direct Energy urges the department to consider the definition of customer classes for which hourly or similar pricing should be made available.

customers of their wires business. Retail suppliers have the kind of sophisticated risk management systems necessary to sign longer-term contracts without simply passing all risks on to customers. Companies such as Centrica have the balance sheet strength and credit rating necessary to be credible to new generators and/or capital markets.

Second, the technical and credit pressure that would be brought to bear on utilities that are forced to procure longer term default service supply exposes the utilities to increasingly unacceptable levels of risk for which they receive no reward. The past several years have shown that the risk posed by two- or three-year supply contracts is significantly higher than the risk posed by contracts of one year or less. There is no appeal in a strategy that exposes utilities to increased risk that is ultimately borne by consumers.

Allowing or requiring utilities to use wholesale contracts of two or three years to procure default service would:

- Kill forever the development of a competitive retail market;
- Eliminate the possibility of demand response among customers by hiding accurate price signals;
- Leave consumers exposed to the boom and bust cycle of the generation industry by failing to provide any entities with sufficient incentives to invest in the next generation of power plants to address load growth and plant retirements;
- Violate the Legislature's clear directive that default service prices "shall not exceed the average monthly market price of electricity" as the risk premiums for longer term fixed price wholesale contracts are recovered in the default service rate; and

- Place unseen credit and market risk onto consumers, as it will be the consumers who ultimately must pay higher prices when suppliers and/or the utilities default under the arrangements.

Thus there are a multitude of reasons not to move to longer term wholesale contracts for default service. Conversely, there are **no** reasons that favor making such a move. Rather, Direct Energy encourages the Department to turn its attention immediately to producing what was supposed to be in place well before the end of the transition period: a functioning and robust competitive retail market for **all** customers, as the Legislature envisioned.

In addition to the general comments provided above, Direct Energy is pleased to provide the following responses to the specific questions asked by the Department.

RESPONSES TO SPECIFIC QUESTIONS

1. Would smaller customers be better served if power supply for default service is procured using a portfolio of more than two solicitations? Please discuss the advantages and disadvantages of increasing the number of solicitations used to procure default service supply.

Response:

No. In fact, the practice of allowing or requiring distribution companies to adopt more of a portfolio approach to default service procurement would, in many senses, be the worst of all worlds. First, it moves the regulated utility even further into the role of professional electricity trader, despite the fact that (a) the utility is allowed no return on the electricity it procures and resells to its default service customers; (b) that function is no longer within the utility's core competency; and (c) additional solicitations are likely to increase the utility's credit requirements, at increasing costs to customers. Second, portfolio management by the utility displaces a function better served by retail competitive suppliers, who would be better able to match customers needs (which span the continuum from a desire for absolute price certainty to a desire to pay absolutely no risk premium). Third, more and longer solicitations by the utility, as characterized in the Request for Comments, would do nothing to spur investment in new generation. In fact, by delaying or permanently thwarting the development of a robust retail market, more and longer term default service procurements would exacerbate future supply shortages, which can best be addressed by large retail companies that have adequate incentives to invest in new generation to serve their own load.

2. Would smaller customers be better served if power supply for default service was procured for a term longer than twelve months? Please discuss the advantages and disadvantages of using supply terms greater than twelve months. In particular, please discuss:

a. whether longer contract terms are likely to produce lower prices,

b. how such an approach would affect price certainty and market efficiency, and

c. how such an approach could be tailored to accommodate customer migration to competitive supply.

Response:

- Please see General Comments above. Small customers would be poorly served by a move to longer term wholesale contracts for default service.

a. The difficult element of answering this question is “lower than what”? That notwithstanding, for the purposes of this discussion, the Department must recognize that mandating that utilities contract for longer terms for fixed price, full requirements contracts simply means that consumers are taking on larger risks and, therefore, all else being equal, will pay higher risk premiums. This is a well-known result of increasing procurement lengths.

b. As Direct Energy understands the “laddered approach” described in the Request for Comments, such a strategy would, by definition, increase price certainty. Price certainty in this case, however, as has been explained above, comes at the consumer expense of a risk premium. Longer term default service procurements would also tend to decrease market efficiency by further insulating customers from an accurate price signal. Direct Energy believes that regulators and entities that claim to speak for consumers over-emphasize price certainty at the expense of accurate price signals and overall lower costs for smaller customers. The Department and others who claim to speak for consumers must not ignore the risk premium to be paid by all consumers if they were provided with a hedged product of this type. Consumers are doubly harmed in this case, as such a product is likely to stunt the development of a competitive market, thereby denying consumers an opportunity to shop for a product to avoid this risk premium. Over

time this emphasis on price certainty will make both wholesale and retail electricity markets less efficient by blunting the natural demand response that would come from consumers being aware that there are daily and seasonal variations in the cost of electricity.

c. Direct Energy is not certain what it would mean to “tailor” a default service procurement strategy that relied on longer-term contracts in order to “accommodate” customer migration to competitive supply. The only reasonable “accommodation” is that the winner supplier in any procurement must fully own the migration risk. In other words, bidders must make their own assessment of the migration risk and then live with the consequences. The risk that a supplier will, at some point, be called upon to sell at a significantly higher or lower volume than anticipated is a risk that is passed from the utility to the winning bidders.

If by “accommodate” one means “have a neutral or positive impact upon,” then the answer is that it will be very difficult, if not impossible, to move to a default service procurement policy in which the utility relies on longer term contracts and have a neutral or positive impact on customer migration to competitive supply. As discussed above in its General Comments, Direct Energy believes competitive suppliers are better situated than utilities to provide a price-stabilized product to mass market customers. This would be an advantage for competitive suppliers if competitive suppliers were provided an opportunity to serve customers at sufficient volume. Requiring utilities to provide such a price-stabilized offering while at the same time providing no opportunity for scale entry by competitive suppliers does nothing to advance the cause of removing barriers to the development of a competitive retail market for small customers. In fact, it becomes yet

another barrier to entry. If, as many speculate, price stability is a high priority for small customers, then competitive suppliers could be successful at offering a hedged product to compete with a default service offering that reflects the volatility of true “market” prices. But if utility wholesale procurement policy begins to resemble a marketing exercise for default service rather than a program designed simply to provide service at a rate that “shall not exceed the average monthly market price of electricity,” the likelihood that a robust retail market will develop from smaller customers diminishes even further.

3. Would smaller customers be better served if power supply for default service was procured on a statewide basis? Please discuss the advantages and disadvantages of using a statewide approach to default service procurement.

Response:

While the answer to this question depends to some extent on what is meant by the term “statewide basis,” the answer to this question is generally “No.” There are physical restrictions and variations in the regional grid that cause wholesale prices to be non-uniform across the state. The system of locational marginal pricing (“LMP”) that is now in effect in the NEPOOL control area causes wholesale prices to reflect these network restrictions as they play out on an instantaneous basis during the day. There is no reason to permanently shield default service customers - including residential and small business customers - from the price signals sent by LMPs. To the contrary, it is important that consumers in lower-cost areas (e.g., Western Massachusetts) do not overpay in order to subsidize other consumers in high-cost area (e.g., Greater Boston). The only way to prevent this from happening is to not only allow but require default service prices to accurately reflect true differences in the cost to serve different areas on the grid. The Department should also note that while New Jersey holds only one auction for its Basic Generation Service, the tranches are offered for each utility; there is not one price that

applies across all utility service territories. Finally, the Department should recognize that holding one statewide auction may result in market price movements detrimental to consumers as a large volume of load will be seeking to hedge itself at the same time.

4. Would smaller customers be better served if power supply for default service was procured using an auction process (e.g., descending clock) rather than through requests for proposals? Please discuss the advantages and disadvantages of using an auction process to procure default service. In particular, please discuss whether using an auction is likely to produce lower default service prices.

Response:

Direct Energy is not aware of any studies that have examined in an analytically rigorous manner the effect of using an auction versus a request for proposals when procuring wholesale electricity. Either can work. But rather than weighing the differences between RFPs and descending clock auctions, the Department should focus on the real problem—the flawed market structure that continues to hide retail costs such as billing and customer service in distribution rates.

5. Although the term “default service” is statutory, G.L. c. 164, § 1, it has confused some customers because of its unintended suggestion of nonfeasance in performing a legal or contractual obligation. Is there some better or more descriptive term that ought to be used by the distribution companies on and after March 2005?

Response:

The term “default service” is dictated by the statute (G.L. c. 164, § 1B(d)), and is otherwise appropriate. The American Heritage Dictionary, Fourth Edition, defines “default” to include “a situation or condition that obtains in the absence of active intervention.” Princeton WordNet 2.0 defines “default” to include “an option that is selected automatically unless an alternative is specified.” This usage is particularly apt here. As of March 1, 2005, default service is the situation that will obtain for current standard offer customers in the absence of active intervention, either by the Legislature or

the Department. It is also the option that will be selected automatically for these customers unless an alternative is specified, which is highly unlikely to occur in the case of residential and small business customers. The Department should not try to sugarcoat or hide the reality of the situation, namely that small customers have no competitive options after seven years of restructuring.

Respectfully submitted,

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APPENDIX A

Massachusetts Legislative Proposal of Direct Energy 12.2.04

INTRODUCTION

This memorandum describes Direct Energy's proposal for legislation that would amend the Massachusetts Electric Restructuring Act of 1997 ("Act") to further the development of a competitive retail market for electricity in Massachusetts.² The proposal is similar in many respects to the manner in which the Texas retail market was restructured by Texas Senate Bill 7, with certain modifications to accommodate the particularities of the Massachusetts market. This memorandum describes the key provisions of the proposal in greater detail, as well as their advantages over other suggested structures for the post-Standard Offer retail market. The key provisions of the proposal include:

- Structural separation of retail and wires functions
 - Utilities can create affiliated Retail Service Providers ("ARSPs")
 - Utilities offer retail services (e.g., billing, customer service) to RSPs at tariffed rates; RSPs required to use utility retail services in first year after Standard Offer expires
- Creation of "basic electric service" ("BES") to replace default service and current standard offer
 - BES in place from March 1, 2005 through December 31, 2006
 - BES provided by RSPs, who have full legal responsibility for all retail services that compose BES beginning March 1, 2005 (ARSP may also bid on BES if they desire)
- Auction of right for RSPs to provide BES (ARSP can participate if they desire)
 - Initial price for BES set by auction results
 - Auction applies only to residential and small non-residential customers
- Supplier of last resort service ("SOLR") provided by RSP (ARSP can bid if they desire)
 - RSPs bid for right to provide SOLR
 - SOLR service for large non-residential customers reflects ISO New England hourly price

I. BASIC MARKET STRUCTURE

A. Structural Separation of Retail and Wires Functions

The most important characteristic of the Direct Energy proposal is the structural separation of the electric utilities' retail and distribution functions. The proposal calls for utilities to file plans for such a restructuring, which would result in two companies where

² Direct Energy is a subsidiary of Centrica North America.

there is now a single retail utility. One of the companies would be responsible solely for the “wires” function; it would own and operate the distribution plant, including customer premises equipment such as meters. The other company would be responsible for the “customer-facing” retail services; that company would own and operate the commodity procurement, billing, customer service, and collections operations. Other retail service providers (“RSPs”) would compete with each other and the utility’s affiliated RSP (“ARSP”) in the newly structured retail market. In the Direct Energy proposal, the ARSP would be allowed – but not required – to participate in the new competitive retail market as would any participant (with one exception, discussed further below).

The three main benefits of this approach are:

- Removes the regulated utility from the retail business, allowing competitive suppliers (including the ARSP) to build relationships with customers as their “electric company;”
- Allows distribution utility to focus on reliability of distribution and local network systems; and
- Minimizes the utility’s incentive and ability to shift retail costs from the unregulated to the regulated company.

Competitive Retailers Become “the Electric Company”

Under the current structure, customers still view electricity service as essentially a vertically-integrated monopoly. While utilities in Massachusetts no longer own significant amounts of generation, utilities procure it on behalf of nearly all residential customers and provide that service along with distribution and transmission in a bundled retail product. The rates may have been unbundled, but not the service itself. For retail competitors to forge the kinds of relationships that would reward innovation and increased efficiency, they must come to be seen as the “electric company,” rather than being seen as, at best, a company that provides one part of what a customer already receives from his utility. The Direct Energy proposal accomplishes this by turning the customer relationship over to retail companies exclusively, creating the maximum incentive for innovation and economic efficiency while still protecting the characteristics of the customer relationship that are central to the regulated utility’s business (mainly the reporting of outages and other distribution system issues).

Wires Companies Focus on Core Business

Even after divesting their generation assets pursuant to the Act, Massachusetts utilities have maintained an effective monopoly in the retail residential and small business markets. The desire to maintain this monopoly and exploit it at some point in the future has, arguably, distracted utilities from their core business, which is to provide a highly reliable local network and distribution system. All customers rely on this system to receive their power, regardless of the source of that power. Massachusetts utilities should be placed in a corporate structure that provides an appropriate incentive and

focuses the utilities on the reliable provision of delivery service, as opposed to diluting that responsibility with an obligation to provide retail functions.

Structurally separating the wires business from the retail business would force utilities to focus on their core delivery services rather than remaining involved in the vagaries of the retail generation market. Utilities would have no incentive or ability to divert resources from the core business to what would now be competitive, unregulated lines of business. The result would be greater reliability and, perhaps, improved utility financial performance, should this re-focusing on delivery services reduce or eliminate penalties for poor performance.

Costs and Functions More Effectively Separated

Regarding the third point, under the current structure, the retail functions and distribution functions of the utility are not even functionally separated; they coexist in the same company. In implementing the Act, the Department has separated only the commodity generation portion of the retail function, and then only for rate purposes. The responsibility for arranging commodity generation for Standard Offer and Default Service remains with utility employees.

The Direct Energy proposal, in creating two free-standing companies that are structurally separated and subject to a strict standard of conduct, would create strong disincentives to shifting employee functions from the unregulated retail affiliate to the regulated wires company. The former utility employees serving the retail functions would be needed to provide those same services on behalf of the unregulated retail affiliate; the ARSP could not afford to leave behind critical employees or functions in the wires company, even if such an attempt were able to avoid detection in the Department proceedings implementing the proposal. As discussed below, under the Direct Energy proposal, in the first year after the Standard Offer expires, other retail suppliers in a utility's service territory would be required to obtain the customer-facing retail services from the ARSP at tariffed rates. This will ensure the maintenance of staffing levels and revenue to cover the cost of providing those services, reducing the incentive to shift functions and costs to the regulated wires company.

Direct Energy believes strongly that the structural separation of the utility's "wires" function from its function as a retail provider of generation services, which is taken from the Texas experience, is critical to the success of the competitive retail markets in Massachusetts, especially the residential and small business markets. Other plans that do not embrace the structural separation of the wires business from the retail business will always be hampered by an immutable characteristic of such a market structure: competitive suppliers must go head to head with the monopoly utility. So long as utilities believe they have a financial incentive to maintain and, at some point in the

future, exploit that monopoly in the provision of retail services, retail competition will remain stunted.³

In order to bring the benefits of retail competition to Massachusetts consumers, it may be appropriate to provide financial incentives to utilities that are willing to voluntarily separate their retail and distribution functions in this manner. The Act took this approach with respect to divestiture of generating plants which, technically, was not required by the Act. A combination of financial incentives (stranded cost recovery and securitization) plus a *de facto* penalty for retaining ownership (generating plants would have to be transferred to a structurally separated affiliate at a cost equal to the highest per kW sale in the region) made divestiture the clear choice for incumbent utilities in 1997. A similar approach could be effective here, encouraging utilities to support the proposal and reducing the risk that a forced structural separation would be challenged in court.

B. Provision of Wires Services to RSPs by Utility

This aspect of the proposal is essential to accomplishing the goal discussed above of creating strong relationships between customers and retail suppliers. Under the current system, the utility bills customers of competitive suppliers directly for the utility's delivery charges, either as part of a consolidated bill provided by the utility, or in a separate bill where a competitive supplier chooses to bill directly for its generation service. Under the Direct Energy proposal, as in the Texas model, RSPs would, in effect, procure distribution services from the wires company on behalf of their customers. Customers would receive one bill only, from the RSP, which would include all charges.⁴ This is analogous to the manner in which many other retail items are purchased and delivered. When ordering a book or CD from Amazon.com, for example, the shipping charge is listed as a line item on the invoice, but payment is made to Amazon.com; one is not billed separately by the shipper.

In the Direct Energy proposal, the distribution utilities would continue to be responsible for customer metering. While utilities should be allowed to continue their monopoly provision of certain metering services for now, they should not, however, be given monopoly control over the data produced by meters. RSPs should have access to

³ In this respect, while some commentators attempt to draw an analogy between the generation services market and the long distance telephone market, the more apt comparison is to Federal and state attempts to open local telephone service to competition. While Congress mandated in the Telecommunications Act of 1996 that incumbent local telephone companies open up their markets to competitors in exchange for the right to provide long distance service, neither Congress nor the states imposed any requirement for structural separation of the incumbent's "wholesale" services (the provisions of the local loop to competitors) from its retail services (the local exchange service provided through the local loop). The result has been low levels of competition in the local market for residential customers, even as incumbent telephone companies have been allowed to enter (and expand aggressively into) the long distance market.

⁴ Although in the first year after the expiration of Standard Offer RSPs would be required to use the utility affiliate to provide billing and customer service, the RSP would retain full legal responsibility for all aspects of the retail customer relationship, including billing and appropriate allocation of payments to the utility affiliate for the retail services provided. After the first year after expiration of the Standard Offer, RSPs could perform billing themselves, or use the utility to do so pursuant to a private contract. See Section D.

customer data produced by whatever metering technology the utility uses (with customer consent). To facilitate the free flow of this data, the DTE would be required to develop standards for the electronic exchange of data among RSPs and electric utilities.

C. Supplier of Last Resort Service Provided by Competitive RSP

Under the current system, the utility provides Default Service, which is available to customers who are not eligible for Standard Offer service and customers who, for whatever reason, may have lost service from a competitive supplier. Under the Direct Energy proposal, because the utility would no longer have a retail operation, an RSP would provide the service that would be available to those who lose service from an RSP. This service would be known as “supplier of last resort” or “SOLR” service. The DTE would select RSPs to serve as suppliers of last resort based upon a competitive bidding process. The proposal contemplates that there would be one SOLR supplier chosen for each utility service territory, although an RSP could win the bid in more than one service territory.⁵

The SOLR would provide the same type of retail service as it would to other customers, namely generation service bundled with retail services and distribution service procured on the customers’ behalf from the utility. While the structure of the service would be the same for all rate classes, pricing would vary, with SOLR for residential customers providing a longer term, more stable price, and SOLR for larger commercial and industrial customers having prices set no less frequently than monthly. The goal of this approach would be to provide a “last resort” service that, while not punitive, would accurately reflect the uncertainty and expense of providing a service with a highly volatile customer base. Because they are generally much better equipped to access the competitive market, more sophisticated commercial and industrial customers would be exposed to far more of the price risk of the spot market than would residential and smaller commercial customers.

II. MAKING THE TRANSITION TO THE NEW STRUCTURE

A. DTE Reviews Utility Restructuring Plans

Distribution companies would be required to file with the DTE by January 1, 2005 a plan for restructuring their retail operations in order to comply with the provisions of the Act. Each plan would propose unbundled distribution service rates designed to recover distribution costs only, and unbundled rates for other retail services, such as billing and customer service, which would be provided on a non-discriminatory basis to RSPs.⁶ Each plan would also propose an auction of the right to serve mass market retail customers beginning March 1, 2005, as discussed further below. On and after March 1, 2005, distribution companies would be precluded from offering generation or retail

⁵ Should an RSP win the SOLR bid in more than one service territory, the SOLR price for each service territory would remain the bid applicable to that service territory.

⁶ Due to time constraints in implementing the proposal, unbundling and structural separation could be done based on existing utility revenue requirements, avoiding the need for full rate cases for each utility.

services. At that time, both the former Standard Offer and Default Service mass market customers would be served at retail by the competitive RSPs (or ARSP if they choose to participate) who were the winning bidders in the auction. The current Default Service would expire at the end of February 2005, along with the Standard Offer.

B. RSPs Apply for Certification Under New Standards

In the market structure proposed by Direct Energy, the financial health of RSPs and other issues related to payment allocation and processing will be of great importance. The Direct Energy proposal recognizes this by requiring RSPs to meet stringent financial assurance standards. RSPs would have to show that they could meet these financial standards upon application to the DTE for certification as a qualified RSP. (Existing retail suppliers would apply for re-certification under the more stringent standards.) Regarding bill payment, the DTE already requires that payments be allocated on a pro rata basis between suppliers and the utility, a current requirement that should be retained in any future scenario, or modified to provide for distribution company purchase of RSP receivables in appropriate circumstances. Direct Energy is also amenable to reasonable suggestions for requirements governing an RSP's payments to the utility that would put the utility in no worse position than in the current system. In fact, to the extent that highly financially qualified RSPs would be taking on all of the credit risk, the utilities' overall risk should decline, as they would have as "customers" a comparatively small number of RSPs rather than several million individual customers under the current system.

RSPs would be subject to the consumer protection provisions currently imposed upon competitive suppliers; the existing provisions would be modified to provide greater flexibility in meeting disclosure and metering requirements and to facilitate properly-authorized switches of a customer's RSP. RSPs would provide the same low income discount that is currently available to utility customers, which would be funded through a charge that would be collected from all customers.

C. DTE Auctions Right to Serve Mass Market Customers

A key provision of the Direct Energy plan is the means by which mass market retail customers make the transition to the post-Standard Offer market. As contemplated under the Act, Standard Offer customers who did not choose a competitive supplier would be automatically switched to Default Service on March 1, 2005.

Under the Direct Energy proposal, the right to serve the mass market (residential and small commercial) customers of each utility would be auctioned to one or more RSP.⁷ The winning RSPs would provide "basic electric service" ("BES") to these customers for the period from March 1, 2005 through December 31, 2007. The price for BES would be fixed for the period from March 1, 2005 through February 28, 2006. From

⁷ The cut-off for inclusion in the auction would be all customers at or below approximately 25 kW of peak demand level. Because the auction would occur on a utility-by-utility basis, one option would be to use existing rate classes to determine the pool of customers to be included in the auction.

March 1, 2006 through December 31, 2007, RSPs could change the BES price no more than once every six months, upon application to the DTE. After 2007, BES would expire. Customers would remain with the RSP that had provided them with BES. RSPs would thenceforth charge competitive, market-based prices. The need to keep customers from switching to other RSPs in the first few months after the expiration of BES would provide a significant incentive for RSPs to keep prices as competitive as possible.

This plan would accomplish two goals. First, under the auction proposed by Direct Energy, mass market customers would enjoy an additional year of price stability after the Standard Offer expires. This period would provide a cushion in the transition to a competitive retail market, but under a structure that still reflects a market-based price for electricity.

Second, the auction would provide RSPs with a means of scale entry into the Massachusetts market, encouraging the participation of non-utility-affiliated RSPs. This is the one aspect in which the Direct Energy proposal differs from the Texas model. In Texas, all mass market customers were transferred to the utility-affiliated retail provider as of January 1, 2002. While Texas has, nonetheless, seen very robust retail competition, Direct Energy believes the opportunity for scale entry by non-utility-affiliated RSPs will be important to attract a sufficient number of market participants, especially given that not all utilities are interested in remaining in the retail business.

Under the Direct Energy proposal, utility affiliates would be allowed, but not required, to participate in the auction of mass market customers, including in the utility's own service territory. However, like the Texas model, under the Direct Energy proposal, the affiliated RSP (ARSP) would be prohibited from competing against non-affiliated RSPs to acquire additional residential and small commercial customers in the ARSP's affiliated utility service territory. As in Texas, this prohibition would expire once the switch rate in the *number* of residential and small commercial customers switched to a non-affiliated RSP exceeded 35%. This threshold could be met upon completion of the initial auction. Thus, for example, if the ARSP acquired 40% of the customers in its affiliated service territory in the initial auction (meaning that the remaining 60% went to non-affiliated RSPs), the ARSP could begin marketing to acquire additional customers immediately. If, however, the ARSP acquired 80% of the customers in its affiliated service territory, it could not attempt to acquire more customers until the total number of residential and small commercial customers being served by non-affiliated RSPs in its service territory exceeded 35%.

D. Utility-Affiliated RSP (ARSP) Provides Retail Services Through Tariff

Another important consideration in the transition between the current market structure and one in which the utility wires and retail functions are structurally separated is mitigating the impact of the separation on the utility and its affiliate. There is genuine concern that should a significant number of retail customers be transferred to non-affiliated RSPs as a result of the auction, the utility's fixed retail costs, which were

designed to meet the demand of all of the customers in the utility service territory, could be stranded to some extent.

To address this concern, in the first year of the new market, competitive RSPs would be required to purchase certain retail services (mainly billing and customer service) from the ARSP at tariffed rates set by the DTE during the utility's restructuring case. This would provide the utility with a full year to adjust its operations for the new market. It would also assure that the quality of basic retail functions such as billing would not degrade when the new market structure takes effect. During that first year, non-affiliated RSPs would be able to plan their own retail operations so that they would be prepared to take over those functions beginning in the second year, to the extent they so desired. Non-affiliated retailers could continue, if they wish, to purchase those services from the ARSP pursuant to a privately-arranged contract. The strong demand that would arise for billing and customer service operations on the part of non-affiliated providers of BES would give the ARSP an incentive to maintain or improve the quality of the retail services it would make available to other RSPs for resale.

CONCLUSION

Massachusetts electricity customers have received many benefits as a direct and indirect consequence of the Act. Thousands of megawatts of new, efficient plants have been built in Massachusetts and New England. Utility-owned generating plants were divested while at their most valuable. A robust wholesale market has developed. Now is the time to move beyond these gains and secure the benefits of a competitive retail market for all customers, not just the large industrial customers who currently account for nearly all of the electricity sold by competitive suppliers. The best way to bring the benefits of competition to all retail customers is to create a market structure in which retail service must be provided through true retail companies, and those functions are separated from functions that should remain the responsibility of local utilities. Direct Energy's proposal takes this critical step, and does so in a manner that will maximize the benefits to consumers while protecting the interests of all other stakeholders as well.